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RUEHCV/AMEMBASSY CARACAS 3292
RUEHLP/AMEMBASSY LA PAZ DEC LIMA 2930
RUEHGL/AMCONSUL GUAYAQUIL 3951

C O N F I D E N T I A L QUITO 001124

SIPDIS

E.O. 12958: DECL: 12/06/2018
TAGS: ECON EFIN EPET ELAB PGOV EC
SUBJECT: ECUADORIAN RESPONSE TO ECONOMIC DOWNTURN

REF: A. QUITO 1121
¶B. QUITO 1062
¶C. QUITO 831
¶D. QUITO 55

Classified By: Charge Andrew Chritton, Reasons 1.4(b) and (d)

¶1. (C) Summary. Falling oil prices will pressure Ecuador's balance of payments and government finances, although it currently enjoys sizeable international reserves and a budget surplus. On November 18, the Government of Ecuador unveiled a package of measures, including tariff increases on over 900 products, to respond to the global economic slowdown. The measures are intended to relieve balance of payments pressure and, to a lesser extent, help exporters maintain competitiveness. However, the government has not yet indicated how it will address pending fiscal pressure or wage adjustments. End summary.

Limited Short-term Pressure

¶2. (C) To date, Ecuador has faced limited short-term financial or economic pressure from the global economic turmoil. Since Ecuador is dollarized, it has not undergone the sharp depreciation that other countries in the region have faced. Furthermore, it does not have a notable domestic securities market, so it has not experienced pressure in the domestic stock or bond market. The public sector has few immediate financing needs and currently enjoys a large fiscal surplus. International reserves cover over four months of imports.

Banking Sector

¶3. (C) In the absence of a lender of last resort, private banks have traditionally kept a large portion of deposits in offshore accounts to maintain liquidity and the vast majority of those deposits appear to be invested in short-term, secure instruments, such as U.S. Treasuries and CDs.

¶4. (C) While the large banks appear sound, some smaller institutions have been under increasing pressure in 2008 as the government steadily lowered maximum interest rates (reftel C). As part of its economic package, the government announced that it would suspend interest rate reductions until June, 2009. However, on December 2 the Central Bank issued new interest rate ceilings for the month, slightly lowering some rates but also raising rates in two categories; at the same time it announced that it would freeze rates for six months staring in January.

Private Sector Financing Vulnerable

¶5. (C) One short-term point of vulnerability is private

sector off-shore borrowing, which totals almost $7 billion. Based on anecdotal evidence, much of the borrowing is secured by off-shore private sector assets; wealthy Ecuadorian companies and individuals have traditionally preferred to keep their assets secure off-shore and borrow against them, which until recently also brought important tax benefits. However, according to one banker, large international banks which had traditionally lent to multinational companies in Ecuador are cutting back their credit lines. In addition, the banker, who has focused on short-term trade credits, expected that his headquarters would cut trade financing as well.

¶6. (C) The government announced that a state development bank would provide up to $100 million in trade financing and that it is working with the Inter-American Development Bank (IDB) on a $500 million credit line. (The IDB representative in Quito confirmed that the IDB is preparing an emergency trade finance line with the GOE, which would be made available through a state-owned bank to private sector banks that would on-lend to importers and exporters.) In addition, the government announced that it would eliminate a tax on off-shore loans for the banking sector, which would lower the cost of banks securing off-shore financing for onward lending.

Growing Balance of Payments Pressure

¶7. (C) Ecuador's trade account and balance of payments are vulnerable to a global economic slowdown and falling oil prices, particularly since Ecuador does not have a floating exchange rate to help curb imports. Non-petroleum imports increased 40% in the first nine months of 2008, driven by strong domestic demand and financed by high oil prices. For the year through September, Ecuador has a $2.6 billion trade surplus.

¶8. (C) However, the trade surplus has turned to a deficit on a monthly basis. In September, exports dropped largely because of weakening oil prices (although at $89/barrel, well above current prices), and Ecuador ran a trade deficit of $250 million. A rough calculation shows that with oil prices at $35/barrel (roughly what Ecuador currently receives for its blend), and demand for non-petroleum imports and exports holding steady, Ecuador would run a $6.9 billion annual trade deficit.

¶9. (C) In addition to falling oil exports, Ecuador's non-petroleum exports, particularly higher-end goods like flowers and shrimp, will likely be suppressed by falling demand in its principal markets, the United State and Europe. Non-petroleum exports had been growing strongly for the year (up 21%), but slipped in September, which had the poorest performance for non-petroleum exports in a year. Furthermore, Ecuador's other principal foreign exchange earner, remittances, has already slipped 14% in the first half of 2008 compared to the second half of 2007. Tourism income expanded in the first half of 2008, but could slip going forward.

GOE Raising Tariffs and Capital Outflow Tax

¶10. (C) Ecuador's reserves doubled since 2007 to $6 billion, but if oil prices remain at current levels those would be quickly depleted unless Ecuador suppresses demand for imports. Several GOE officials indicated privately that the government did not want to curb capital imports, given the government's emphasis on infrastructure investment.

¶11. (SBU) On November 26, the government raised tariffs on 940 tariff lines, largely consumer goods ranging from food products to cell phones and some types of motor vehicles. The government raised the tariffs to the WTO-bound ceilings. For many products the ceiling is around 25-30 percent, and for most products the tariff increase was 10 percentage points (more details septel). The affected tariff lines

represent slightly over $1 billion in imports.

¶12. (U) In addition, as part of the November 18 announcement, the government said that it would raise the capital outflow tax, initially set at 0.5% (reftel D), to 1%. When it sent draft legislation to the legislative body, it also proposed eliminating the exemptions to the capital outflow tax, which include payments for imports and profit remittances.

¶13. (SBU) The government sought to help exporters by exempting them from income tax withholding requirements (but not income tax), which will provide limited cash flow relief.

Missing Pieces to the Puzzle: Spending, Wages, Demand

¶14. (C) The government program announced on November 14 does not address key issues such as spending, public and private sector wages, and suppressing demand.

¶15. (C) In the first half of 2008, petroleum revenues accounted for 44% of public sector revenues, up from 25% in ¶2007. Expenditures increased 76% in that same period. The government has multiple buffers and/or options to adjust on the fiscal side. Easy ones include: current budget surplus ($1.8 billion in the first half of 2008), cash reserves (over $1.4 billion), ability to cut or delay investment projects, underpaying the Social Security Institute (IESS), formally borrowing from IESS, and the fact that domestic petroleum subsidy costs (currently approximately $4 billion/year) will fall with falling oil prices. Potentially more challenging options include borrowing from international lenders and raising domestic fuel prices.

¶16. (C) Several senior Ministry of Finance officials told Emboff in mid-November that the government was reviewing options to cut spending but added that the government did not want to slow expenditures on infrastructure investment, given the numerous pressing infrastructure needs. They acknowledged that public sector wages were a key contributor in increasing public sector expenditure, and said that the government was reviewing wage increases but had not made any decision. One official also acknowledged that increasing public sector spending would fuel demand for imports, and said that he had requested a study of the impact.

¶17. (C) A number of Ecuadorian exporters, particularly those in labor-intensive industries, complained that they lost competitiveness when the government raised the minimum wage 18% in 2008. The Labor Minister recently declared that under the new constitution, the government alone would have authority to set the new minimum wage (previously the business and labor sectors were formally consulted). He did not identify how large the 2009 adjustment would be, but opined it should compensate for 2008 inflation (currently slightly below 10%). If so, that would further erode Ecuadorian competitiveness, particularly since the dollar has appreciated against the currencies of Ecuador's neighbors and competitors.

Comment

¶18. (C) Ecuador has some buffers, notably sizeable cash and international reserves, so that it can absorb, for the time being, the sharp fall in oil prices. It has a degree of flexibility on the fiscal side, but less so with the balance of payments, since at current trends it would go through its international reserves in less than a year.

¶19. (C) In the absence of a floating exchange rate, increasing tariffs was one of a handful of policies the Government could implement in response to the balance of payments squeeze. However, the tariff increases and raising the capital outflow tax alone will likely not be sufficient if oil prices remain at their current levels for an extended period. It would help if the government also constrained

demand and helped maintain export competitiveness by slowing government spending and implementing a modest wage increase for 2009. The government has not yet indicated what it will do in those areas, but they will be politically difficult measures to take with an election in April 2009. It could also maintain foreign financing options by servicing its international debt, currently a question mark with the November 20 release of a report that is highly critical of the Ecuador's public debt (reftel A and B).

¶20. (C) The government has had a relatively free hand in economic policy and has not had to make difficult decisions because of high oil prices over the past two years. To an extent, this has allowed the government to exercise both its populist and pragmatic instincts. In a more constrained environment, we do not know which tendency will prevail.
CHRITTON